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A MANDATE FOR DEVELOPMENT: THE FUTURE OF THE WORLD BANK

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT INSTITUTIONS AND FINANCE

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

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A MANDATE FOR DEVELOPMENT: THE FUTURE OF THE WORLD BANK

THURSDAY, SEPTEMBER 5, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT INSTITUTIONS AND FINANCE,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to call, at 10 a.m., in room 2222, Rayburn House Office Building, Hon. Stan Lundine (chairman of the subcommittee) presiding.

Present: Chairman Lundine, Representatives LaFalce, Levin, Bereuter, and McCandless.

Chairman LUNDINE. The Subcommittee on International Development Institutions and Finance will come to order.

Even in the absence of the ranking member, who I know is on his way, I believe we will get started. For the benefit of the members who are here now and may not be able to stay to the end of all of the questions, I am with mixed feelings informing you that this will be the last in this series of hearings. The intention of the subcommittee had been to conclude this extensive series of hearings by having the testimony of the administration, following all of the other witnesses.

At the request of Secretary Baker, he would rather not testify, and his schedule makes that difficult, prior to the IMF-World Bank meeting in Seoul, Korea, in October, and therefore we have agreed that he will testify after that time in October, but that our report will not wait until that time, so I would say that Mr. McNamara, who is our witness today, is an appropriate concluding witness to enlighten the subcommittee.

I think that, unfortunately, the bells have rung, and we have a purely procedural vote, which I hope will not be followed by others, and I think probably that the best thing to do would be to excuse ourselves and recess for as short a time as we can, to get to the House floor and back. We will be recessed for approximately 10 minutes.

[Recess.]

Chairman LUNDINE. The subcommittee will come to order.

I ask unanimous consent that the opening statement that I have—I think it is in front of everyone—be included in the record in its entirety. Without objection, that will be included at this point in the record.

[The opening statement of Chairman Lundine follows:]

OPENING STATEMENT
OF
CHAIRMAN STAN LUNDINE
HEARING OF THE INTERNATIONAL DEVELOPMENT INSTITUTIONS AND
FINANCE SUBCOMMITTEE
September 5, 1985

Good morning. As many of you know this Subcommittee has, over the past several months, been holding a series of hearings examining international debt, trade and development issues. Testimony received from our many expert witnesses has shown above all else the interrelationship between these issues and the relative fragility of our present international economic system.

A recurring theme that emerges from the hearings we have been holding is that our own economic prosperity here in the United States is seriously threatened by these problems. To give just a single example, recent employment figures here in the U.S. indicate that more than two million jobs have been lost or not created because of the drop in our exports to developing countries during the 1980's.

The developing countries themselves have paid the highest price as a result of current international economic instability. The people of Latin America and Africa have seen their standard of living decline to early 1970's levels or worse. In Latin America political pressures are growing which threaten many of the fledgling democracies trying to gain a foothold. In Africa, where the majority of the poorest countries in the world are located, widespread famine again threatens millions of innocent lives and a rapidly growing debt crisis has further sapped these already struggling economies.

In the face of this adversity I strongly believe that we must move quickly to find some answers before events overtake us. The multilateral development banks in particular have a responsibility and are in a key position to meet these challenges. We on this Subcommittee hope to make a real contribution to this process when we issue our report on the future role of the multilateral banks and U.S. policy towards those institutions.

I can think of no more qualified individual to comment on the role the World Bank and the other MDBs can play in helping the developing countries overcome the present obstacles to development than our distinguished witness today -- Robert McNamara.

Mr. McNamara served as President of the World Bank Group for more than 12 years from 1968 to 1981. From 1961 through 1968 he served Presidents Kennedy and Johnson as Secretary of Defense. Prior to his Administration service he was the President of the Ford Motor Company. Mr. McNamara currently serves as a Director on a number of corporate boards including Corning Glass, Royal Dutch Shell and the Bank of America. He is also Chairman of the Overseas Development Council and is associated with a number of non-profit organizations focusing on a wide range of policy issues.

Chairman LUNDINE. Mr. Bereuter, do you have an opening statement?

Mr. BEREUTER. Yes, Mr. Chairman, thank you very much. I join you in welcoming your distinguished witness, and very much look forward to some display of the infinite reservoir of knowledge that he provides us with. I would join you in asking unanimous consent that my opening remarks be made a part of the record.

Chairman LUNDINE. Without objection, they will be made a part of the record.

[The opening statement of Mr. Bereuter follows:]

OPENING REMARKS BY CONGRESSMAN DOUG BEREUTER

Mr. Chairman, it is a pleasure to be back with the subcommittee. I too join the chairman in welcoming today's distinguished witness. He brings an infinite reserve of expertise to our oversight hearings.

We are halfway through the decade of the 1980's and the visions of famine and depravation sometimes give us the impression that little has changed in the last 20 years. Some things have improved since Mr. McNamara's time at the World Bank. These successes are, in part, due to the large accomplishments of the Bank, notably in the Indian subcontinent.

But, famine, poverty and desperation have not disappeared. Development theories change and new ideas come and go. Indeed, "policy reform" has replaced "basic human needs" as the day's favorite medicine. Meanwhile, Latin America has "lost" a decade of growth and development due to the economic crisis.

I firmly believe that for numerous smaller, debt-strapped middle income countries, what is truly necessary is the political will to confront the financial and political dimensions of the development problem. While there are signs of improvement in some countries, we cannot expect austerity to go on forever. Rightly or wrongly, Latin Americans are increasingly feeling as if they are assuming a disproportionate amount of the debt burden. In terms of U.S. security interests, it is a difficult and dangerous situation to perpetuate.

I'm looking forward to hear our witnesses testimony. Thank you, Mr. Chairman.

Chairman LUNDINE. I can't think of anyone more qualified to comment on the role of the World Bank and its other multilateral development bank than our distinguished witness today, Robert McNamara. Mr. McNamara served as president of the World Bank group for more than 12 years, from 1968 to 1981. From 1961 through 1968 he served Presidents Kennedy and Johnson as Secretary of Defense. Prior to his administration service he was president of the Ford Motor Co. He currently serves on a number of corporate boards, including one in the 34th Congressional District of New York, I might say, and he is chairman of the Overseas Development Council and is associated with a number of nonprofit organizations focusing on a wide range of policy issues.

Mr. McNamara, we have your statement, and it will be included in the record in its entirety. You may proceed as you wish.

STATEMENT OF ROBERT S. McNAMARA, FORMER PRESIDENT OF THE WORLD BANK

Mr. MCNAMARA. Thank you, Mr. Chairman. I understand you would like me to open with 5 or 10 minutes of comments summarizing the statement that lies before you. If that is agreeable to you, I will start in that way.

Chairman LUNDINE. Certainly.

Mr. MCNAMARA. Then I will be very happy to take your questions.

Chairman LUNDINE. Thank you.

Mr. MCNAMARA. I am very grateful for the opportunity that you have given me to address you on the requirements for financial assistance to the developing countries; the role of the international financial institutions; and U.S. support for the multilateral approach to development assistance.

For the purpose of our discussion, I would like to divide the roughly 100 developing countries into 3 groups. In the first group I would place the low-income countries, excluding India and China which I will treat separately. These low-income countries have a total population of about 600 million. Their average income per capita approximates $200 per year, compared to roughly $14,000 per capita in the United States.

In the second group I put India and China, with a total population of about 1.8 billion and average incomes per capita approximating $280 per year. In the third group are the middle-income countries, including those of Latin America. These middle-income countries have a population of about 1.1 billion, with average incomes per capita of about $1,300 per year.

I believe it is in our economic interest and in our political interest to see the nations in all three groups achieve reasonable rates of economic and social advance. Economically, we benefit from the trade that such progress brings and without that economic progress, political disorders are bound to arise, with ripple effects that affect our security.

Four factors affect the rate of economic advance in the developing countries. I am going to discuss only one of them in any detail, but I want to mention the other three.

First, and perhaps most important, is the growth in the industrialized nations, particularly the United States. These nations are the export markets for the developing countries. It is through export trade and the foreign exchange earnings from that trade that the developing countries receive the major part of the funds which they require for investment.

The second factor affecting rates of growth in the developing countries is their access to the markets of the industrialized nations.

The third factor, of course, is the set of domestic economic programs followed by the developing countries. I will have more to say on that in a moment.

Finally, the fourth factor, which is the major subject of our discussion this morning, is the level of external financial assistance, the funds to be added to the domestic savings of the developing countries for the purpose of laying a foundation for their long-term growth.

As I have said, the most important single assistance we can provide to the developing countries is to assure a reasonable rate of growth in our own economy. And the second most important action we can take is to assure free access to this economy for their exports. Both of these factors, a reasonable rate of growth in our own economy and free access to our market, are in jeopardy. But even if they were not, long-term sustainable growth in the developing countries will not occur without sound macroeconomic policies.

In the past, such policies have been lacking in many of those nations. High fiscal deficits, low savings rates, barriers to exports,

stimulants to imports, inefficient use of capital, lack of incentives to maximize agricultural production have often been common. However, the economic crises of the past decade have forced the governments of most developing nations to reexamine their domestic policies, and to take the difficult political decisions which are required to correct them.

If you have read this morning's paper, you will see that in Guatemala and Bolivia, where they have just recently announced such decisions, riots are occurring in the streets. But the crises of the past decade have forced many of these nations to take the difficult political decisions to put their house in order.

To do so they need external financial assistance. Such assistance can catalyze the structural adjustments required, and can extend the economic and social cost of such adjustments over an acceptable period of time.

For many of these developing countries, the process of adjustment can be thought of as passing through two phases. In the first phase, the requirement is to reduce inflated and unsustainable current account deficits to acceptable levels. To assist in this process is the function of the International Monetary Fund. As you know, it extends short-term credit to support the adjustments which are needed to bring about a balance of payments equilibrium.

In the second phase, the countries must move to a new series of adjustments, a set which will produce long-term growth. Such growth is a prerequisite for social stability. In many of the recently established democratic regimes it is a necessary condition for their political survival.

In the second phase, the World Bank—whose function it is to provide long-term credit and technical assistance to facilitate the macroeconomic changes and productive investments which are required for growth, as contrasted to stabilization—has a unique role to play.

The low-income countries are dependent on the International Development Association of the World Bank as their main source of funds. But because of a failure of the United States to agree to the refinancing of IDA at the levels agreed to by all other donors, the amount of credit available from that institution has been cut by about 20 percent in real terms. This is hurting all of the low-income countries, including those most in need, the countries of sub-Saharan Africa.

I placed two low-income countries, India and China, in a special category. I did so because the world, at present, does not have even the semblance of a plan to help these nations meet their long-term financial requirements. They have been advised by some world leaders to look to the commercial banks and the private markets for their external financing.

Were they to take that advice and obtain 100 percent of their external financial requirements, as modest as those requirements are in per capita terms, from the commercial banks, the debt crisis the world would face in the year 2000 would make our present debt problems look insignificant by comparison.

It is true that India and China can make greater use of the commercial markets, but it is not true that they can prudently obtain even the majority of their external financial requirements from

such markets. It would be very unwise for us to advise them to do so.

The third group of countries, the middle-income nations, includes the large debtors of Latin America. As we are beginning to realize, while they have passed through their liquidity crisis with the help of the IMF, which has extended some $30 billion to $40 billion of new credit to them over the last 3 years, they have yet to move to programs of sustainable long-term growth. To do so, in the face of the near drying up of commercial credit, they will need heavy support from the multilateral financial institutions, particularly the World Bank.

You may conclude that I am suggesting a massive increase in the United States Foreign Aid Program. That is not the case. I do, however, question the desirability of cutting foreign aid by 20 percent from the level of some $20 billion in fiscal year 1985 to something on the order of $16.7 billion as is proposed for fiscal 1986. This is shown on page 18 of the statement that lies before you.

Indeed, I want to emphasize that if by "foreign aid" we mean what is commonly understood by the term, that is to say financial assistance to low-income countries, allocated on the basis of need, and in a way that makes the most effective contribution to long-term development, then the United States does not have a Foreign Aid Program.

Page 18 shows that only $2,570 million or 15 percent of the total of $16,700 million proposed for foreign aid for fiscal year 1986 would go for such development assistance. And only 6 percent of the total of the $16.7 billion Foreign Aid Program is to be used in support of multilateral financial institutions as opposed to bilateral military and economic programs.

Some would have us believe that it is the U.S. Congress that has lost faith in development assistance in general and multilateral financial institutions in particular. I don't believe that is the case. I frankly hope it will be the Congress which will see fit to shift the shape and the size of our Foreign Aid Program to better serve our national interests and to better meet the requirements of the developing nations, particularly the poorest among them.

Mr. Chairman, that completes my opening remarks. I would be very happy to try to answer your questions and those of your fellow members.

[The prepared statement of Mr. McNamara follows:]

The Role of the Multilateral Finance Institutions in Development Assistance

A Statement by Robert S. McNamara
To the House Sub-Committee on International Development Institutions and Finance

Mr. Chairman and Members of the Committee.

Thank you for giving me this opportunity to address you on the important and topical issue of the role of the international financial institutions and U.S. support for the multilateral approach to development assistance.

I want to place particular emphasis today on the plight of the poorest countries and what the U.S. can and should do to foster their development. I do this because in recent weeks most media coverage of their affairs has concentrated on the immediate problem of famine and on the question of how food aid might most quickly and efficiently be given. Yet the real solution to this problem lies in helping these countries overcome their longer-term development difficulties.

The middle-income developing countries also continue to face difficulties -- especially vis-a-vis their external indebtedness -- despite the fact that they have reaped more of the benefits of growth in the industrialized world.

In both types of country the multilateral development banks -- in particular the World Bank -- have an important role to play in helping them surmount their problems.

Let me say at the outset that I am concerned about the direction which U.S. foreign assistance policy is taking at present. U.S. aid programs are meeting neither the test of self-interest nor that of responsible international behavior. One sees this clearly in the foreign aid appropriations budget (see the Appendix on page 18), where there has been an obvious shift in the balance towards security assistance and away from economic development assistance, an action which I consider to be short-sighted and regrettable. One sees it also in the increasing trend in the U.S. aid budget towards bilateralism, and away from a multilateral approach. This is particularly apparent in our relations with the multilateral development banks, where we are letting initiative and opportunity slip away from us.

Low-Income Countries and Multilateral Assistance

Those developing countries suffering most from the reluctance of the U.S. to provide an adequate level of economic assistance are the low-income countries. This group of the world's poorest nations, those with annual incomes per capita below $410 (compared to our $14,000), includes more than half of the world's population and 80 percent of the world's approximately one billion people living in "absolute poverty" -- human beings who are literally on the margin of life. Most of the people living in absolute poverty are in Asia -- in Bangladesh, India, Pakistan and China. However, most of the lowest income countries are in Sub-Saharan Africa, where annual real per capital growth fell by an

average of almost one percent in the 1970s and more rapidly in the last few years. At present, these countries rely on "official development assistance" for 80 percent of their external capital and several tragically also rely on food aid for their physical survival, as we all know.

It is in this context that the International Development Association (IDA) -- the World Bank's concessional loan window -- has a crucial role to play. More than 90 percent of IDA lending is to the low-income countries and IDA has a proven track record of delivering high quality projects. Objective assessments of this critical arm of the World Bank, such as that undertaken by the U.S. Treasury in 1981, have concluded that IDA does its job exceptionally well. The average economic annual rate of return on its projects is 18 percent, despite the fact that it operates in the least hospitable environments. Its project rigor is no different than that applied on IBRD projects and it is actively engaged in building viable institutions and supporting needed policy change.

Yet there has been a sharp reduction in the volume of IDA's resources available for lending to the poorest countries. The U.S. refusal to make a contribution to the seventh replenishment of IDA (IDA-7) in excess of that made to IDA-6 has had the effect of curtailing the financing of long-term productive investments and the institutional strengthening required to support economic growth. IDA-7 is more than 20 percent lower in real terms than IDA-6 as a direct result of the

U.S. action. And even though the share of IDA's resources going to India has dropped from 40 percent to 22 percent, and China, given the size of its country, has received only minimal amounts, IDA credits to Africa have declined by an annual average of almost 5% in real terms.

The humanitarian response of the western world to the famine in Africa is well known. What is less well known, however, is that the revival of economic growth experienced by the U.S. and a number of other industrial countries in recent years, has brought little benefit to the low-income developing countries. Growth in the poorest countries of Sub-Saharan Africa, has not rebounded; per capita incomes declined by about 3 percent annually between 1980-1984; and a general improvement in their terms of trade has been offset by a fall in export demand, which declined by more than 2 percent each year from 1980 to 1984. In these circumstances, Africa's debt burden has risen sharply.

The ability of many poor countries to benefit from the recovery in the West was limited by the cumulative effects of inappropriate government policies, and institutional obstacles. But their capacity to undertake the needed policy reform and structural change was constrained also by diminishing net aid flows. And, in addition, the immediate need to stabilize their economies restricted their ability to invest in areas essential for their long-term development -- education, health, family planning -- as well as in those programs necessary to sustain more rapid growth, such as agricultural research, irrigation, extension, reforestation, and rural infrastructure.

Infrastructure in many African countries, for example, continues to erode. Capacity utilization remains low and capital stock is not being maintained or replaced. Many African Governments have undertaken significant and initially very high-cost economic reforms, such as increasing production incentives for farmers, reducing subsidies on agricultural inputs, substantially paring public investment programs and even divesting state-owned enterprises. However, expectations that these reforms will lead to increased domestic production and greater flows of domestic and foreign private investment cannot be fulfilled in the absence of adequate infrastructure, that is, transportation, utilities, and other basic facilities and services, and adequate complementary imports essential for the production effort, such as fuel, fertilizer, seeds and spare parts.

My concern about the general inadequacy of IDA-7 was widely shared amongst the donor community, and much of this concern is focussed on economic conditions in Sub-Saharan Africa. This concern is widely shared in the United States as well, and to our credit we have been one of the leading contributors to the relief efforts underway there. Nevertheless, it is widely recognized that Africa's needs go far beyond short-term relief measures, as outlined in the World Bank's Joint Program for Africa, published in September 1984. There was a wide measure of support for the Bank's analysis of Africa's problems and the emphasis on the need for changes in development policy, as well as for increased assistance. This support was not limited to the donor

countries, for the Commonwealth heads of state and representatives of the recipient community also acknowledged the force of the arguments for the Joint Program.

In February this year, a financial facility, known as the Special Facility for Sub-Saharan Africa, was set up by donors under the administration of IDA to help implement the parts of the Joint Program targeted at economic policy reform. Sixteen countries have so far pledged support to the Facility, whose total resources are in excess of $1.2 billion. The largest contributors have been France and Italy, with Japan and Germany having pledged substantial amounts of associated financing. The Facility will lend to those low-income countries in Sub-Saharan Africa that are implementing policies to correct the distortions built up over the last decade. These imbalances were, of course, aggravated by the global recession and debt crisis. The funds will be highly concessional, and will be available for maintenance and rehabilitation, and for adjustment operations at a sectoral or economy-wide level. They will be of substantial help to countries like Ghana, Senegal, and Zambia, where the authorities are reorienting their economies, but are short of the resources needed to carry policy reforms through.

The policy reforms to be supported are an extension of those already backed by IDA. They include the liberalization of key prices in the economy -- interest rates, producer prices for agricultural goods, import tariffs, and so on. These are all areas of reform which the U.S. supports. The multilateral character of the Facility will

enable it to support these changes effectively and in a larger number of countries. It will be able to draw on the Bank Group's accumulated experience in the actual and potential recipient countries, and in the administration of adjustment operations. It is not yet too late for the U.S. to join the Facility, which will be operating in 1985, 1986, and 1987.

But it is even more important for the U.S. to look ahead to IDA-8. Many of the same issues will be followed up in the next replenishment, in respect of both its African operations and its activities in the other low-income countries. In all of these countries, the Bank is supporting changes and developments which are fundamentally in the U.S. interest. But these are not only changes in policy. They include changes in investment programs as well -- new programs for reforestation, a major effort to halt desertification, a much expanded program of applied agricultural research, and continued investment in education and training. These activities require funding.

Without increased resources for development, the emergency food relief effort will have to be repeated again and again. Adequate resources, by contrast, will enable the low-income countries to continue the reorientation of their strategies, to remove the disincentives to private investment, to improve on the efficiency of resource use, to gradually reverse the decline of their incomes and to resume growth. In the absence of adequate external support, countries now undertaking these reforms will face rising social tensions and the pressures of growing poverty, and the international community will be confronted with intermittent threats of widespread starvation and the ripple effects of political disorder.

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The Middle-Income Countries and Multilateral Lending

The middle-income developing countries, those with annual incomes per capita above $410, are caught in the same rapidly changing economic environment that is producing serious strains in the industrialized world. They are trying to adjust quickly to changes in energy balances and trade structures, and to deal with the uncertainties surrounding world growth, while simultaneously seeking to alleviate basic bottlenecks in infrastructure, agriculture, and human resources. Many of them also face a serious — indeed in some cases a seemingly intractable -- debt problem.

Progress in these countries will depend on the following critical factors: (a) resumption of world economic growth; (b) resistance to protectionism in industrialized nations; (c) continued access to external capital; and (d) greater efficiency of domestic policies.

On the trade side, it is estimated that each one percent in world economic growth has been associated with a five percent rise in the volume of manufactured exports in middle-income oil-importing LDCs. For this reason, the prolonged recession and the resurgence of protectionism have been harmful to countries which have pursued outward-looking policies. For many developing countries, export volumes fell in the 1982-84 period. Export prices also plummeted -- in fact, commodity prices were lower in real terms than at any time since World War II -- so that developing country purchasing power shrank. Recession plus

protectionism proved to be a double burden on LDCs with mounting debts. Of course, the recovery in the past two years has brought relief, and it has been matched by stringent austerity programs in many middle-income countries and major efforts at structural adjustment. This permitted a number of the most heavily indebted middle-income countries to draw back from the precipice of a debt disaster. But the costs have also been high: at mid-decade the average per capita income of the middle-income countries is no higher than it was at the beginning of the decade; and only about a tenth of our own per capita income. Some countries, even with continued good progress and a supportive, open and growing global economy, can expect to be no better off at the end of the eighties than they were at the beginning.

International finance will continue to be an essential requirement for economic growth and development. Middle-income LDCs which rely heavily on commercial capital are — with few exceptions — continuing to face great obstacles in borrowing funds because of the continuing economic difficulties of a few key borrowers and the changing attitudes of commercial banks, particularly those in the U.S. Being creditworthy is no longer a guarantee of gaining access to capital. This is neither sustainable nor desirable.

A number of middle-income countries in Latin America, the Mediterranean Basin and Asia, now need sustained adjustment programs and long-term external capital in support of the restructuring of their economies toward growth and development.

As severe debt problems emerged in these and other middle-income countries during the early 1980s, the IMF played a critical role in assisting them in dealing with their short-term credit requirements. As you know, the Fund is charged with providing short-term credit to facilitate the economic adjustments which countries must make to achieve monetary stability and balance-of-payments equilibrium. It did so with remarkable success. But the scope for further net drawings from the IMF is limited -- indeed most of the drawings in 1982-84 will have to be repaid over the next few years. These countries now must move to a second phase of adjustment -- one that will produce growth on a sustainable basis. This is a prerequisite for social stability and the political survival of democratic regimes, some of which have only just been reestablished.

In this second phase, the World Bank, whose function it is to provide long-term credit and technical advice to facilitate the macro-economic policy changes and the productive investment required for growth as opposed to stabilization, has a unique role to play.

And its role will increase over the next several years. As noted, the IMF has no net additional resources for those countries which it has supported heavily in recent years. The commercial banks are reducing their lending to developing countries and their net exposure will grow slowly, if at all. The IDB can, and does, supply substantial amounts of capital to Latin America but its shareholders have limited sharply the amount it can lend to the largest debtors -- Argentina, Brazil, Mexico and Venezuela.

In these circumstances, if the World Bank is to perform its task -- for which there is no substitute if we are to avoid wide-spread write-downs of existing debt -- its lending program must continue to grow as sound investment opportunities are developed and sound programs of policy change are put in place. And this means the Bank must be adequately capitalized.

The funds paid in by the U.S. as capital subscriptions to the Bank since 1946 have yielded a very high return on investment. These funds, together with the capital subscriptions of other countries, have enabled the Bank to make more than $113 billion in loans, supporting development expenditure (and, incidentally, exports of its contributors), well in excess of that amount. If the Bank is to continue to do its job, more capital will be required. I cannot think of anything more shortsighted than for us to fail to respond adequately to this need on a timely basis.

U.S. Interests and the Multilateral Approach

It is a clear lesson of the post-war period that political stability does not ensue from military strength, in the absence of broadly shared economic development. Building up military hardware in LDCs is not a substitute for building viable economic institutions.

A preoccupation with security concerns, to the detriment of economic concerns, will not prevent the unravelling that is sure to occur if economic conditions deteriorate too far. This process, which I fear is well underway, judging by the frequency of international debt reschedulings and changes of governments, will be very costly to U.S. economic and political interests if it continues. Much has been invested in and gained from the international trade and financial system and in its strength lies the best hope for future peace and stability.

I would argue that America's long-term interests are well served by the multilateral financial institutions. Multilateral sources of assistance are effective precisely because they are not spigots which are turned on and off, depending on current foreign policy considerations. Strategic interests, after all, are essentially long-term. Regional security interests, political stability, and the development of democratic political values are not overnight phenomena; they emerge out of long-standing and constructive relationships and broad-based economic development. In this area, as I have pointed out, the World Bank and IDA serve the interests of the United States in many parts of the world. It is one of the great ironies of development that critics of these institutions should view them as insufficiently responsive to U.S. concerns when they are viewed in the field as promoters of market-based development and Western economic interests. I submit that they are one of the most effective pillars of our security in these areas by their contribution to growth, development, and open economic systems.

The United States was the leader in the establishment of IDA and has traditionally relied heavily on IDA to deliver resources, technical assistance, and development advice to the poorest nations. Yet, despite its strong economic position in the industrialized world, and the remarkable strength of the dollar, the U.S. has seen fit to reduce its share in IDA's funding dramatically. America now contributes 25 percent of IDA resources, despite the fact that the U.S. produces close to 40 percent of the OECD's output and income. This retreat from international responsibility is seen in the aggregate by America's relatively weak performance in measures of official development assistance as a share of GNP, where we rank last among the seventeen countries of the OECD. It is all the more vivid, however, with respect to the poorest nations, which currently receive U.S. commitments of less than one-tenth of a penny of each dollar of U.S. GNP.

The U.S. Foreign Aid Budget in FY86 and the Multilateral Approach

From what I have already said, you will appreciate that I am very concerned with the proposal to drop the total budgeted U.S. foreign aid, in FY85 only 0.5 percent of GDP, by nearly 20 percent from $20.4 billion in FY85 to $16.7 billion in FY86 (see the Appendix, page 18). This drop comes at a time when developing countries' financial needs remain acute, and when U.S. GDP -- one barometer of our ability to give -- has just registered a considerable increase.

Equally as disconcerting is the fact that the only component of foreign aid which it is proposed to increase is military aid. Military aid would grow by over 15 percent, from $5.8 billion in FY85 to $6.7 billion in FY86 (excluding off-budget credits). This is the extension of a trend in which military assistance has risen from 25 percent of total foreign assistance in FY80 to 40 percent in FY86.

It should also concern us that by far the great majority of the foreign economic assistance provided is heavily weighted towards short-term aid and is directed almost exclusively to a small number of middle-income countries through the Economic Support Fund (ESF). An amount of $4.0 billion has been budgeted for this Fund and, when combined with military assistance, represents about 65 percent of the proposed aid budget. This is money spent in support of today's short-term political interests rather than long-term strategic and development goals. Only 35% of the total Foreign Aid Appropriations request for FY86 is for "Development Assistance", relevant for long-term development -- and by including food aid I have used a very liberal interpretation of development aid. More than half of the Development Assistance will go to middle-income countries and only $2.5 billion -- 15% of the total -- will be for low-income LDCs. Indeed, if by Foreign Aid we mean what is commonly understood by the term -- financial assistance to low-income countries, allocated on the basis of need and the most effective contribution to long-term development -- the U.S. does not have a Foreign Aid program.

If we exclude food aid and some other emergency relief programs, the core of U.S. foreign assistance to the poorest nations is USAID and IDA. U.S. appropriations for IDA, the key institutions in channeling assistance to low-income LDCs, would amount in FY86 to $790 million, down from $900 million in FY85. This represents no more than 4 percent of total U.S. foreign aid. I find this to be totally disproportionate with our vital interests in the countries of Sub-Saharan Africa, as well as countries like Bangladesh, Burma, Sri Lanka, India, Pakistan and China. Moreover, as I have pointed out, it serves to reduce by $2.25 billion the amounts that other donors are willing to provide to the Association for its FY85-87 lending program. I would add, incidentally, that the funds which donors commit to IDA are only called upon as needed to finance disbursements, so that the cash outlays associated with the FY85-87 appropriations will not occur until the late 1980s and early 1990s.

Some would have us believe that it is the U.S. Congress that has lost faith in international financial institutions and development aid to low-income countries. I frankly hope that it will be the Congress that will see fit to shift the balance of our assistance program so that bilateral aid -- primarily security assistance and financial support of middle-income countries -- doesn't claim 92 percent of the budget. This would leave multilateral aid -- almost totally development assistance to low-income countries -- at only 8 percent.

While in a budgetary sense bilateral and multilateral aid may compete for funds, in an economic sense they are complementary. Multilateral aid helps to develop a framework of sound economic policies, sensible investment programs and strengthened institutions -- all of which are essential to the effective use of bilateral aid funds. It is when this framework is inadequate, and when international institutions are weak, that donors compete, conflict and overlap. The result is ineffective aid, poor projects and heavy debt burdens. Although it may take a while to emerge, proposed cutbacks in multilateral aid will weaken institutions in LDCs and ultimately make bilateral programs more costly and less effective. Seen from a different perspective, bilateral aid programs may be initiated or terminated depending on political exigencies, but development progress is unlikely to ensue from such volatility funding.

The American people have once again demonstrated their generosity in mobilizing massive assistance to help the victims of the African drought. Let us combine the same generosity with a vision for the long-term needs of the developing countries. Development is a tenuous and complicated process for which there are no easy solutions. The most effective approach is to support those efforts which are successful.

America's vital interests are widely believed to be critically at stake in the Middle East and Central America. I would submit that

they are equally critically at stake in Latin America, on the plains of Kenya and Sudan, and in the rice paddies of Bangladesh. The U.S. must be faithful to its allies, but the U.S. must also support the international economic system which is the foundation for a free and open world. I urge you to consider seriously whether the breadth of America's current and future interests are being served by the failure of the U.S. to properly support the multilateral financial institutions and the over 100 independent nations and 3.3 billion people they serve.

U.S. Foreign Aid Appropriations by Fiscal Year a/
(in millions of dollars)

					FY86		
	FY80	FY82	FY84	FY85	Low-Income Countries	Middle Income Countries	Total
Security Assistance							
Military Assistance b/	2205	3902	6479	5801	477	6194	6671
Economic Support Fund	1972	2919	3146	6498 c/	486	3537	4024
Other (net) d/	- 72	22	100	99	23	77	100
Total e/	4105	6843	9725	12398	986	9808	10795
Development Assistance							
Bilateral Assistance							
Development Aid	1856	1847	2151	2649 f/	887	1247	2134
Food Aid g/	886	1000	1590	2716 h/	700	980	1680
Multilateral Banks							
IDA	1072	700	945	900 i/	690	60	750
Others	406 j/	562	379	885 i/	245	352	598
Other (net) k/	287	443	791	875	50	708	758
Total	4507	4552	5857	8026	2570	3348	5919
TOTAL FOREIGN AID	8612	11395	15583	20424	3557	13156	16713

Memo Items:

Development assistance to low income LDCs:

	FY84	FY85	FY86
as % of US Federal Budget	.30	.36	.24
as % of US GNP	.08	.10	.06
per capita in US	$12.08	$16.26	$10.94

Footnotes

a/ Based primarily on Tables in AID FY86 Congressional Presentation Vol. 1. FY80, 82 and 84 data are "actuals"; FY85 figures are "estimates"; and FY86 is based on the Administration's request.

b/ Beginning in FY85, all Foreign Military Sales items were made on-budget, either as loans or grants; previous years which included guarantees as off-budget items have been adjusted in this table to show the combined total of both; off-budget amounts included in these totals are:

FY80	$1450	million
FY82	$2923	million
FY84	$4401.2	million

c/ Includes $2285 million supplemental in FY85.

d/ Includes peace keeping operations, anti-terrorism and narcotics assistance programs.

e/ Of these totals, $4830 million is for Egypt and Israel in FY84, $6592 million in FY85 and $5117 million in FY86.

f/ Includes $140 million supplemental in FY85.

g/ Food aid figures are program levels. Of these totals, $263 million is for Egypt in FY84, $237 million in FY85 and $222 million in FY86.

h/ Includes $609 million supplemental in FY85.

i/ Includes $237 million supplemental in FY85.

j/ Excludes $830 million in callable capital appropriation.

k/ Includes Peace Corps, Trade and Development Program, OPIC, International Organizations, Migration and Refugee assistance, Inter-American Foundation, African Development Foundation.

General Notes

1. Unallocated amounts in each category of assistance, excluding the multilateral banks, have been prorated to the low-income and middle-income countries, according to their corresponding shares in the allocated portion of the type of assistance.

   The share of IDA and other multilateral assistance directed to the income countries has been assumed to be 92% and 41% of the corresponding totals, respectively.

2. The low-income countries are those whose per capita GNP in 1981 was below $410, and the middle-income countries, with per capita GNP above $410.

Chairman LUNDINE. Thank you very much for your statement and your brevity. In keeping with my tradition, I will question last and I will call on Mr. LaFalce. Do you have a question or questions?

Mr. LAFALCE. One of my principal concerns is not only the past Third World debt crisis but the potential future crisis that could erupt, and I am wondering what role you might see the World Bank playing to help alleviate the present and potential Third World debt crisis.

Mr. MCNAMARA. Sir, let me make a comment first about the potential debt crisis, and then specifically answer your question about the role of the World Bank. You probably know as well as I do that there is a wide difference of opinion among financial and political leaders as to the nature of the crisis. Such individuals as former Secretary of State Henry Kissinger, Felix Rohatyn, a leading New York investment banker, Peter Keenan, an outstanding professor of finance from Princeton; Lord Harold Lever, a major European financial authority, and a number of other individuals of similar experience, believe there is no solution to the debt crises that does not involve a writedown of the debt.

Now, that means somebody must bear the loss. There are only two groups that could do so. One is the stockholders of the institutions that lent the money, basically the nine major money-center banks in the United States, and the other is the U.S. taxpayer.

Now, the stockholders of the banks can't bear the loss because the total credits outstanding are so large in relation to the capital of the banks that to accept any substantial writeoff of the debt would make it impossible for the banks to carry on normal lending operations. Not only would they have to stop lending to international borrowers, but their domestic lending would freeze up as well. It is impossible to write down any substantial amount of that debt and charge the loss against the stockholders. And I submit to you, as you know better than I, the U.S. taxpayers will not accept the loss.

The IMF quota bill, which was the foundation of the IMF's program for developing nations in meeting their liquidity crisis—a bill which cost the taxpayers essentially nothing—passed the Congress by only five votes. There is no indication whatsoever that the taxpayers of the United States are prepared to accept any significant loss in the writedown of the Third World debts.

I want to suggest to you that it is not necessary that anyone accept the loss, if we act intelligently in relation to these problems. By that I simply mean that these nations, particularly such nations as Brazil, Mexico, the Argentine, are potentially wealthy nations. Brazil is 20 percent larger than the continental United States. Per square mile of territory, it is richer than the United States. The only thing it lacks is petroleum. So far they haven't found significant supplies of liquid petroleum, but they have other assets to offset that. They have a literate, educated, technically capable population to utilize those assets.

They need time, however, to lay out and implement a long-term development program to follow the stabilization program imposed by the IMF during the liquidity crisis. The IMF has imposed conditions in return for the financial support that Brazil needed. Essen-

tially those conditions, designed to achieve a short-term balance of payments equilibrium, result in a shrinkage of imports and an imposition of austerity. That can only be tolerated politically for a limited period of time.

What is needed now is to help these nations move to long-term sustainable growth. This is very, very difficult. It requires the kinds of decisions that the New York Times reports the Bolivians and Guatemalans are revolting against. If nations such as Brazil, the Argentine, and Mexico, lay out long-term development programs, and if they are willing to introduce the macroeconomic policies and undertake the structural adjustments which are needed to put them on the path of sustainable growth, then the World Bank and other multilateral financial institutions should be called upon to provide the financial assistance to make that growth possible.

In addition, the Bank will have to do the same as the Fund did, catalyze the movement of other financial resources. The Fund, under the really brilliant leadership of Jacques de Larosiere was imaginative in mobilizing resources far beyond the limits of the assets of the Fund to address the liquidity crisis. The World Bank should be expected to do the same in addressing the growth crisis.

The net transfer of funds of the Bank approximates $1 billion to $2 billion per year. That should be at least quadrupled. But more important than the quadrupling of the net transfer of the Bank would be the catalytic role which the Bank could play in mobilizing other financial resources, these have essentially dried up.

Mr. LAFALCE. It is your judgment that the World Bank has not been playing this catalytic role; is that correct?

Mr. MCNAMARA. As I suggested, I think that the problems faced by many of these developing countries—and I use Brazil, Mexico, and Argentina to illustrate them—can be thought of as passing through two phases. In the first phase, one we are just now completing, the problem was primarily liquidity, short-term balance of payments equilibrium. That was a phase that should be dealt with primarily by the Monetary Fund.

The Fund dealt with it brilliantly. It mobilized and transferred on the order of $30 to $40 billion to assist those countries to undertake the types of adjustments that were needed to move to a current account equilibrium.

But we are now moving into the second phase, the phase of long-term sustainable growth. That is a phase that is peculiarly the function of the World Bank to deal with. It must be called upon to do so, and it must be equipped to do so. It is not.

Mr. LAFALCE. If I can ask one final question, to be a little bit more specific, though, I understand what you are saying, that they should perform this catalytic role to help promote economic growth. It is not only an economic problem; it is a growth problem as opposed to a liquidity problem. But you couple that catalytic role with utilization of the private sector.

Mr. MCNAMARA. Yes.

Mr. LAFALCE. Now, how would you have the World Bank utilize the private sector more, in order to serve as the catalyst for this growth problem?

Mr. MCNAMARA. Well, to speak in general terms, let me again use Brazil as an illustration.

Brazil has passed through the liquidity crisis. Essentially, their balance of payments is in equilibrium. However, they have not laid out a long-term program of sustainable growth. Additional structural adjustments are needed. Additional macroeconomic policy changes are needed. These are going to be very, very difficult—politically difficult. Brazil will need external finance to facilitate introducing these structural adjustments.

But, if you were given 20 years to do two things in Brazil, No. 1, achieve a rate of growth sufficient to maintain social stability; and No. 2, a rate of growth sufficient, to service the existing and future debt—you could do that. Brazil is rich enough to pursue such a development program.

What is needed are two actions: further economic changes within Brazil itself; and external capital not now available.

The World Bank could not supply, by any means, all of the external capital that could be effectively employed in support of long-term development programs in these developing countries. It, however, can supply much more than it has, and in the process it can do exactly what the IMF did, it can mobilize private capital.

You are all familiar with the way the IMF did it. It was pretty rough. The IMF essentially said to the commercial banks,

> You have got a hell of a problem on your hands. These countries can't pay, and they won't pay. They want IMF help. We want to tell you we will supply IMF help on two conditions: No. 1, that the countries act to reduce their current account deficits, shrink imports, shrink fiscal deficits, expand their exports, and No. 2, that you, Mr. Commercial Bank, will put up 5 percent more credit this year.

Now, the commercial banks almost revolted at that. But they didn't have any real alternative. If the banks wanted their loans serviced, they had to support the IMF Program.

It was rough. It was arm-twisting. But it worked.

Chairman LUNDINE. I have to interrupt and ask a follow-up question.

But the World Bank doesn't have the same leverage, do they?

Mr. MCNAMARA. It can have, yes. Part of the problem has been that its level of lending, particularly for this type of loan—what I am going to call a structural adjustment loan—has been very, very low indeed.

I shouldn't speak with any authority. I have not been associated with the Bank for 4 years and I don't wish you to interpret what I say as official Bank policy. However, having spent 13 years in the institution, and having followed it since my departure with great interest and great admiration, I want to say to you that there is no institution in the world better qualified to advise these nations on how to move toward long-term sustainable growth than the World Bank and there is no institution better qualified to advise both parties, debtors and creditors, how to avoid writing off debt in ways that will be disadvantageous to both.

But, to do so, the Bank has to do two things: it has to increase its total lending above present levels; and even more importantly, it must reshape its own lending program.

I would guess that the World Bank's "structural adjustment lending" in fiscal year 1985 did not exceed 15 to 20 percent, of its total lending. That percentage should at least double. And, as I said earlier, its existing lending levels should be increased substan-

tially in order to permit a quadrupling of its net transfers from a level of $1 billion to $2 billion to something on the order of $4 billion to $6 billion.

With that additional leverage, it could accomplish what I think the IMF accomplished in inducing nations to accept the necessary changes in macroeconomic policy.

Chairman LUNDINE. And inducing additional credit to be extended.

Mr. MCNAMARA. Exactly. And inducing the private markets to extend additional credit on terms that are prudent for the private markets.

I am a director of a large commercial bank. I am not about to support that bank throwing money down a rat hole. I have a responsibility to stockholders. As a director of that bank, I would insist that the additional credit, which I believe the bank should extend to developing countries, be extended only if associated with long-term development programs that give a reasonable prospect of those loans being repaid on the terms on which they were extended.

Chairman LUNDINE. Mr. Bereuter.

Mr. BEREUTER. Thank you, Mr. Chairman.

Mr. McNamara, it has been estimated that some of the Latin American countries—the capital flight from those individual countries may well be as large as the total of foreign debt of those nations.

Can you recommend any adjustment programs or policies or actions that the MDB or the IMF might take to reverse that flow and sustain retention of the domestic capital within those countries, actions that are not now being taken?

Mr. MCNAMARA. Well, first, you are absolutely right on the issue of capital flight. For example there were large movements of capital out of Mexico in the early 1980's. The peso had not been devalued. It was way overvalued. If you were an intelligent Mexican, you wouldn't have kept your wealth in pesos; you would have shifted it into dollars. So, obviously, one of the primary requirements in all of these cases, to avoid capital flight, is to keep a proper relationship between the local currency and external currencies, particularly the dollar.

That is not always done. So that is one of the most important single actions.

But, beyond that, more is necessary. Conditions must be established which will attract local capital for investment in the local economy. That is the essence of growth in these societies. It is a condition that we must help them meet.

Dealing with Mexico as an illustration, we have a 2,000-mile border with that country. There is no way we can keep Mexicans in Mexico if they want to cross a 2,000-mile border. The Mexicans want to live in Mexico, but the operative word is "live," and if they can't live in Mexico you are not only going to have a capital flight but you are going to have a human flight. So, it is in our interest to help them live in Mexico.

Now, how do we do it? We take their "product." That is difficult, because their product competes with ours. But they need jobs. They have the most rapidly growing labor force of any large country in

the world. It is growing at 3.4 percent a year, and it is going to continue to grow at that rate for the next 10 to 20 years. The people who will enter the labor force in the next 10 to 20 years are already born. That labor force is going to mushroom over the next decade or so. They must have jobs someplace. If they can't get them in Mexico, they are going to have them here, with all of the political and economic problems that will bring. So, we have to help Mexico develop the economic structure that will absorb those people productively.

That can be done. It means helping Mexico accept the very, very difficult political decisions necessary to devalue their currency, expand their exports, control their imports, and reduce their fiscal deficit. By the way, the present government—President De la Madrid and the Finance Minister, Mr. Herzog—have already made major reductions in the deficit—I think, have done admirably. They have cut it by more than 50 percent in relation to GNP, an extraordinarily difficult task when you recognize what trouble we are having in reducing ours.

So I want to come back to your question. Capital flight is important. It has occurred in many countries. It will stop when the international financial institutions and the country involved together work out "we," I am speaking—I should say the international macroeconomic policies that will attract that capital to productive investment in the country.

It can be done. A lot of capital has been flowing back into those nations in recent years.

Mr. BEREUTER. Thank you.

I have one more question around the subject of parastate organizations, these national corporations that we find so many of in Latin America. I will just make the bold statement that in general they are very inefficient——

Mr. MCNAMARA. I would endorse that.

Mr. BEREUTER [continuing]. And ask you a couple questions related to them.

First, do you think there has been a bureaucratic bias within the MDBs toward such parastate organizations, perhaps a bit more acutely demonstrated in the past than now?

Second, do you think there ought to be a sale of some or all of the resources of individual selected organizations, or do you think that there is a possibility that an equity position might be taken by American banks and then sold to privatize in part or in total some of these organizations?

Could you address this general subject and give me your own ideas, please?

Mr. MCNAMARA. The parastatals have developed in the developing countries for varying reasons. In many of the countries—and this is particularly true in Africa—the parastatals were formed because of a lack of private capital and lack of ability to handle the function through the private market. That is one set of circumstances.

Another is what you call a bureaucratic bias. Some governments preferred to carry out the function through a state owned as opposed to a privately owned organization.

To address your last question first, is it likely that commercial banks or other private sources of capital would, if the opportunity were offered to them, take equity positions in these parastatals? I would say generally not. It is going to be very, very difficult to stimulate equity flows into most of these developing countries.

Fortunately, many of them are beginning to see that they will benefit from additional equity flows. But it is going to take a number of years before those flows are expanded. The risks are very, very great, and the private equity investors are unwilling to accept those risks in relation to the rates of return available at the present time.

Conditions are changing, though. What you call the bureaucratic bias is much less evident today than it was 5 or 10 or 20 years ago. There is much, much more interest in many of these countries in expanding their private sector.

One sees that in some of the major countries in Asia. As a matter of fact, part of the stimulus to the change has been the great success of some of the smaller countries of Asia—Korea and Malaysia, for example. Many of the countries elsewhere in Asia and in Latin America and Africa are observing the benefits to society from strong private sectors and they are therefore developing environments that will stimulate them.

But I come back to your basic point. I don't believe there is going to be a dramatic change in the role of parastatals in the next 2 to 5 years. There will be a gradual change away from the numbers we presently have.

What I hope will change is the measure of the performance of those parastatal organizations. The measure of performance should be identical with that of any private enterprise. The goods should be bought and sold at commercial prices, and the parastatals should be measured in terms of the rate of return on the investment that the society has dedicated to them.

If you adopt that measure of performance, then you will go a long way toward meeting the problems you pointed to: inefficient operations, inefficient use of capital, inefficient use of human resources.

Mr. BEREUTER. Thank you.

Chairman LUNDINE. Mr. McCandless.

Mr. MCCANDLESS. Thank you, Mr. Chairman.

Mr. McNamara, we are talking here about a situation in the world where we have international markets no longer separated by oceans or time, to speak of. The critics of the World Bank and the International Monetary Fund have charged that the World Bank has subsidized uneconomic production in borrowing countries that unfairly competes with the U.S. goods and exports.

How can the World Bank reform its practice to avoid this result in the future if, in fact, this is true?

Mr. MCNAMARA. Well, in the first place I don't think the charge is justified, sir. I think I know what you are talking about.

A small percentage or World Bank group loans—at most 3 to 5 percent of a total of $150 billion—would fall in the category you are speaking of. That is to say, activities competing in what some would say are unfair ways with U.S. producers.

However, even with respect to these instances, the Bank has had a stated policy of never financing an investment in a developing country that is not based on what I am going to call comparative advantage. That is to say, the Bank will not support investments which cannot yield satisfactory returns at world prices.

On average, the World Bank, IBRD and IDA investments yield roughly 18 percent on capital employed, which is certainly a competitive rate of return at world prices.

Now, the problem comes when, in these 3 to 5 percent of the cases I mentioned, while the investment is perfectly justified on the bases of rate of return and is clearly in the interest of the developing country, it may be competing with a U.S. investment which needs subsidization and which cannot operate at world prices. Some of the U.S. copper operations, for example, fall in that category, and that is the case that brings the criticism you are speaking of.

I think the answer is not to withhold capital from an investment in a developing country, which can operate productively and profitably at world prices, but rather to help the U.S. industry become competitive at world interest prices. Either the U.S. firm should get out of the business entirely, or it should adjust its activities to raise its efficiency, reduce its costs, and achieve profits at the world price level.

Mr. MCCANDLESS. We talked about your category, one of the three categories that you outlined in your statement, low-income countries——

Mr. MCNAMARA. Yes.

Mr. MCCANDLESS [continuing]. 600 million people, $200 per capita income level. When the World Bank is approached by one of these countries, one could take from the private sector—a loan is granted based upon the ability to repay. That is the way it has always been in my area of endeavor. And that the ability to repay is based upon the income generated, as well as those other factors that are pretty basic in the loan business.

Are you satisfied that these plans for development that moneys would go to in this scenario that we are discussing are being loaned on the basis of a plan for repayment in that country, and the development that is necessary to create that money and goods and services for repayment?

I guess what I am concerned about is, are we going to build into the system, as we currently have it, so many Brazils, so many Mexicos, because we do not take those primary steps to begin with, and as a result find that we have this after-effect?

Mr. MCNAMARA. The short answer to your question is "yes." The Bank does insist that there be a high prospect of repayment of the loan. That is the short answer.

If you wish me to, I will expand on that answer.

Mr. MCCANDLESS. It would be up to the chairman.

Chairman LUNDINE. Certainly.

Mr. MCNAMARA. The longer answer is that the Bank has been making loans for almost 40 years, and in that time it has, as I suggested to you, loaned through IBRD on the order of $115 billion, and through IDA on the order of $30-odd billion. It has not lost one single dollar in that 40-year period.

Its profits on the IBRD loans have totaled about $7 billion. By the way, the total capital paid in to the IBRD by the United States is something on the order of $500 million.

Now, lest you think this is done with mirrors, I should hasten to add that the United States, in addition to paying in to IBRD $500 million in capital, has provided guarantees which have been helpful in the Bank's sale of bonds to the commercial markets. But the Bank basically operates on a small paid-in capital, a substantial guarantee authority, a sale of its securities on the free markets of the world, and a relending of those funds in the context of technical advice and economic conditionality designed to ensure that first, the particular investment being financed by the funds yields a satisfactory rate of return, and second, that the country borrowing the funds proceeds in such a way as to have foreign exchange on hand sufficient to repay the loan when it comes due.

On balance, the Bank has been very successful. Of course, it has had failures on individual projects. To learn from the failures, we began in 1970 to audit every single loan upon its completion, based on the very detailed files sent to the Board of Directors at the time the loan was approved.

An independent group, reporting directly to the Board of Directors, audits the investment to determine whether the objectives of the investment, the rate of return, and so forth, have been met. Those reports are submitted to the Board, 150 or 200 a year.

At the end of the year, they are summarized. The names of the countries are removed to avoid embarrassment, and a summary of the report is then made public.

Now, those reports do show some failures. You would expect that. But I would say that the average rate of return supported by the audits, is about 18 percent and about 90 or 92 percent of the loans are successful. All of them are repaid because we insist that even though the loan fails to achieve its purpose, the country is liable to repay, and they have repayed.

The reason they repay 100 percent of the loans is that they know that 92 percent of the time we and they together have succeeded, and if they want additional funds in the future they had better repay today.

So that is the answer.

Mr. McCandless. Thank you.

Thank you, Mr. Chairman.

Chairman Lundine. Mr. Levin.

Mr. Levin. On page 14 of your testimony, you say—you may have said it before, but it is still dramatic—that we really don't have a Foreign Aid Program if by "foreign aid" was meant it is financial assistance to low-income countries allocated on the basis of need in the most effective contributions to long-term development.

Mr. McNamara. That is correct.

Mr. Levin. We have heard some testimony during these hearings that would argue this way—and I think all of us would appreciate your comment—that we really do have a Foreign Aid Program now but it has a different emphasis; that, instead of an emphasis on projects, there is an emphasis on policy change. And instead of the emphasis—and this was touched on by Mr. Bereuter's question—instead of an emphasis on transfers to the public sector, we have a

concentration on building up private sectors within developing countries.

That critique, this argument, goes—the critique of your statement is that it emphasizes money, and it doesn't emphasize the end result in terms of policy change, private sector development, et cetera.

I think it might be helpful, with your rich, long background in development and in financial matters generally, if you would comment on that, because that is the basic argument of the administration today.

It isn't a bold statement that we have a deficit in this country so we have to reduce development assistance. That isn't what is said primarily. Instead, what is argued is that there has been a necessary shift.

Mr. MCNAMARA. Let me first deal with the issue we are talking about, development assistance, because it is within the development assistance program I think that you are suggesting there has been or should be a shift from——

Mr. LEVIN. This argument of administration witnesses.

Mr. MCNAMARA. Exactly.

I should say the administration would argue that within the development assistance there should be a shift from, I will call it, non-private to private projects.

Mr. LEVIN. And to the policy.

Mr. MCNAMARA. And policy implications.

Mr. LEVIN. And policy changes.

Mr. MCNAMARA. Policy changes.

Mr. LEVIN. Rather than all of these kind of endless——

Mr. MCNAMARA. But let me first go back to my basic point: out of what is called U.S. foreign aid appropriations totaling $16.7 billion, only $2.6 billion is for development assistance defined as the dictionary defines it. So, the first point is you can't escape those figures.

Now, what is the rest? Most of the rest is for military assistance. This isn't development assistance. This is a military assistance program. Out of the $16.7 billion, $6.7 billion is directly for military assistance; another $4 billion is for support for it.

Chairman LUNDINE. Can you retain that thought just a moment?

Mr. MCNAMARA. Yes.

Chairman LUNDINE. I am going to turn a mythical gavel over to Mr. Levin so that we don't interrupt you, and I am going to run over and vote and get back.

Mr. MCNAMARA. Very well.

So, the majority of this money, some $10 billion out of $16.7 billion, not only doesn't go to the low income countries, it goes for military assistance. As Secretary of Defense, when I faced similar situations, I said many, many times to this Congress that, at the margin, we would buy more security by shifting a dollar from military assistance to development assistance. I felt that way 20 years ago; I feel that way today.

So, the first point I make is that the development assistance is essentially nonexistent. It is $2.5 billion out of $16.7 billion.

Now, within that $2.5 billion I think your question has great relevance. Shouldn't the $2.5 billion be associated primarily with pri-

vate investment and with policies designed to stimulate the privatization of economies?

Mr. LEVIN. And other policy changes, so we can have some back and forth, as is the custom of doing.

One of the arguments for the small amount of development assistance—and I think your critique—is if there is an emphasis on policy change instead of these concrete projects, and if there is an emphasis on privatization, that they cost less money. The administration tries to meet your argument about the shift by saying, all right, there is more worth in whatever it is called at the time—this is the administration argument—but we are undertaking development assistance efforts that cost less but will be more effective.

Mr. MCNAMARA. I don't think there is anything to the cost-less argument, but there is something to the point that private investment and policies that stimulate the growth of the private sector are important.

I have spent most of my adult life in the private sector. I think I know the merit of the private sector and the free market and the stimulus to efficiency that comes from privatization. But I also know the limits of privatization.

Moreover, I would direct your attention to the point that, of the $2.57 billion going to development assistance, $690 million of that is scheduled for IDA. The great bulk of that is for private activities. It is for agriculture.

Agriculture in these developing countries is 90 percent in the private sector. As a matter of fact, I can't think, offhand, of any one of the low-income countries in which agriculture is not a private sector function.

Now, I hasten to add that in many of these countries the macroeconomic policies and the macroeconomic framework which private agriculture operates is not optimal to maximize production from those private farms. The cost/price relationships have been distorted. Why? Because of the subsidization of food in the urban areas.

The countries may have dictators, but the dictators are looking for legitimization of their roles. They seek urban support. They buy the urban support by cheap food. The cheap food in the urban areas tends to reduce incentives in the rural areas to maximize production.

This is exactly the kind of macroeconomic policy change that must be insisted upon. The Bank makes that a major condition of its agricultural loans.

But, to go back to my first point, although the major portion of the financing included in the U.S. Foreign Aid Program for development assistance is for private agriculture, more needs to be done to shape the policies, of the recipient countries to maximize the incentive to maximize production. That is true.

Second, in many of these countries, much needs to be done to stimulate savings and to provide an environment within which those savings can be applied productively in the private sector. But if everything possible could be done—and everything possible is not now being done in that area—there would be a tremendous need for additional capital to finance the necessary infrastructure.

You have to have roads. You have to have schools. You have to have large-scale irrigation projects. You need the kind of infra-

structure which we put in place in this country in the 19th century and in the first half of the 20th century.

Mr. LEVIN. So I think you are saying that while there has to be an emphasis on policy changes, it isn't really something very new.

When you were president of the bank, how much were you dealing with policy changes relating to developing countries?

Mr. MCNAMARA. It was by far the most important activity of the Bank. We had, I would say, the largest group of economists in the world assigned to nothing but that. Ours was even larger than the Monetary Fund. But the Monetary Fund and the Bank together concentrate on policy change.

Their greatest contribution, frankly, is not the transfer of funds. Their greatest contribution is the stimulus to policy change.

Now the emphasis on policy change has brought the Monetary Fund into some disrepute because the policy changes which it recommended to deal with this liquidity crisis were very onerous in political terms. They led to levels of austerity that caused great suffering in the developing countries—but far less suffering then would have occurred without the IMF persistence.

It is one thing for us to pull in our belt. It is another thing to pull in your belt when you don't have anything to pull it in on. And that was the condition in many of the countries. That is why there is a revolt reported today in Bolivia.

When the Monetary Fund, for example, asked the Government of Egypt, as one of the conditions for its credit, to eliminate food subsidies for the middle class—in other words, to reduce the fiscal deficit of Egypt—there were riots in the streets. Sadat was nearly overthrown. He was forced to reverse the change.

It wasn't that the Monetary Fund was wrong, at least not in principle, but it was probably wrong in the timing.

The World Bank has made similar mistakes. But it is essential that these two institutions continue to provide advice to the developing country governments, policy advice to ensure that the assets of those countries, human and physical, are most effectively used in the interests of all of the people of the countries.

Mr. LEVIN. I personally think that your comments in this regard are most helpful and really need to be heeded, because there has been the argument that this focus on policy changes is something new, and that the focus on privatization is something brand new, and in essence can take the place of money, and the assumption, the implication is that previous policies emphasized money to the almost total disregard of policy changes, including privatization.

I see the chairman is back. I need to vote.

We handled this in part.

Chairman LUNDINE. It got us enough time.

Mr. LEVIN. So that we could continue this.

Mr. MCNAMARA. May I take 30 seconds just to address the point you make. Policy changes are not new, and policy changes are not a substitute for money. Moreover, policy changes have been initiated by many of the developing country governments with tremendous effect. Let me just give you one illustration It is the case of India. As a result of the introduction of policy changes and sharply targeted investment, the cereal grain production of India increased 100 percent, adjusted for weather differentials, between roughly

1968 and 1978. It went from roughly 65 million tons to roughly 130 to 135 million tons of cereal grain. That was through the private sector. It was a tremendous success.

Mr. LEVIN. I agree and I hope we can shout it from the rooftops, and I will shout it as I go over and vote.

Chairman LUNDINE. I am going to try to pick up on this, and I hope I am not being redundant, but I presume that you are in favor of some degree of conditionality being imposed on MDB lending to achieve some internal economic policy changes. As we understand it, the Bank, the World Bank and the other regional development banks are more and more trying to achieve more market oriented internal policies, and I gather, though, that you think that is an appropriate policy?

Mr. MCNAMARA. In my paper I have tried to indicate that I believe that the World Bank financing should be expanded substantially, but only in association with programs developed by the developing countries to achieve long-term sustainable growth, and conditionality of that kind I strongly support.

It is unfortunate that the word "conditionality" carries with it connotations that are quite unacceptable to many developing country governments today, but putting that aside for the minute, most developing country governments today understand that they must reshape and restructure their economies, to lay the foundation for long-term growth.

There will be frequent arguments, I am sure, between the Bank and the governments of those countries as to exactly what shape the restructuring should take and over what period of time it should be carried out. I will just give you an illustration.

I can recall a time when, while talking to the President of Ecuador, I said to him that, with the price of gasoline at 18 cents a gallon in Ecuador, compared to a world price of $1.25, unless they raised their price to the world level they would cease being a petroleum exporter by 1985. Under these circumstances I said the World Bank would not continue loans to Ecuador. To do so would be wasting our resources. We would be pouring our resources into a society that was wasting its own by excessive consumption and by a failure to export.

He said to me, "If I raise the gasoline price from 18 cents to $1.25, there will be a revolution tomorrow. The poor people live outside of town, and they ride on buses to their jobs in town. And if I raise the gasoline price, I have got to raise the bus fares and there will be riots."

What to do? Well, the answer is (a) the president must move, from 18 cents to $1.50. Otherwise his resources are being wasted and the Bank's funds are being wasted. But the Bank must recognize the political problem. It is a reality. A precipitous increase will cause the government to be overthrown. What would we accomplished by that? Nothing. Therefore we worked out a transition over time.

Now, that is what I mean by conditionality. It is what I would call action that is in the country's interest, that is very difficult for them to take, but action that is set in relation to what is politically tolerable.

Chairman LUNDINE. You have used one example, which is sort of market orientation. How about the other, of restrictions on investment in the country? Is it reasonable to expect the lesser developed countries to reduce the amount of local content requirements and all the other means that they have that restrict investment from abroad into their own country?

Mr. MCNAMARA. Well, I think it depends on the particular situation. I was very interested while I was an officer of Ford to expand Ford's investments, particularly in Latin America. We did so in Mexico, Brazil, and the Argentine. At the time we did it, Mexico I recall had a local content requirement, and a very substantial one. This was understandable. They were trying to build their supplier industries, and they wished us over time to reduce the amount of parts that we manufactured in this country, and sent to Mexico for assembly.

So long as the local content requirements were administered on what I am going to call an economic basis, I wouldn't object to that. It is basically infant industry protection, and this is a perfectly acceptable form of protection in economic textbooks. It is a form of protection we in this country used in the 19th century and early 20th century.

Chairman LUNDINE. That leads me to the trade barrier point. You have said that one of your major criteria, I think your second criteria for the development of these countries, was that they be free, have free access to the markets of the developing countries, particularly the United States.

Mr. MCNAMARA. Yes.

Chairman LUNDINE. Is it fair for us to say, "But your markets have to be as open to our products as ours are to yours?" Let me qualify that, particularly with regard to the third level of countries. I am not talking about——

Mr. MCNAMARA. The middle-income areas, the Brazils.

Chairman LUNDINE. Right.

Mr. MCNAMARA. And my answer is it depends, and I am not trying to waffle.

Chairman LUNDINE. I was afraid you would say that.

Mr. MCNAMARA. In the first place, it is not in the interest of the developing countries to maintain excessive protection forever, and I will give you an illustration. When I first went to Turkey in 1968, as president of the World Bank, we were financing a development bank there, the purpose of which was to invest in private enterprise in Turkey. I looked over the loans made by the development bank and found that the profits of the enterprises financed by this development bank were very high, 25 to 30 percent a year. I couldn't understand it. Then I looked and found the industries were highly protected.

Now, what was developing was a "hothouse" economy that was not in the interests of Turkey. Turkey's industry was not exporting. They couldn't export. They couldn't compete in the world markets. They were so damned inefficient that the only thing they could do was sell their goods in Turkey behind a high tariff wall. Now, that was not in the interest of Turkey.

And so the answer to your question is I am in favor of appropriate protection in a developing country to permit infant industries

to get started, but then they should be quickly exposed to the pressure of the world market which would strengthen them to compete effectively in that market.

The country that has done that superbly well, of course, is Korea, although, initially, it too operated behind protective tariffs, and still does to some considerable degree. On balance, many, many developing countries today maintain tariff protection that is excessive, that is contrary to their own interests.

Chairman LUNDINE. I gather from your comment that the World Bank should increase, I think you said quadruple the amount of——

Mr. MCNAMARA. Net transfer.

Chairman LUNDINE. No, of structural adjustment lending that it does. Therefore you would expect that there would be less project lending?

Mr. MCNAMARA. Yes, less percentagewise at least.

Chairman LUNDINE. Right.

Turning to India and China, by your testimony do I gather that you do not completely support the idea that they should be weaned off from IDA lending in order to enable greater IDA funds to go to Africa?

Mr. MCNAMARA. No, that isn't really what I said.

Chairman LUNDINE. No, I know it isn't what you said. That is why I wanted to ask.

Mr. MCNAMARA. I will come to that. What I said was that I have read that a senior official of a Western government advised India and China to go to the private markets for their external financial needs. I think that would be very imprudent.

Second, I would, however, expect India and China to use commercial credit to a greater degree than they have, but to a limited degree. I would expect them to use IBRD funds, and similar multilateral financial institution funds, to a much greater degree than they have. Particularly in the case of India, I would expect to see some transfer of borrowing from IDA to IBRD. In neither case would I wish to see a total, or even a primary, reliance on the private markets.

Within IDA, therefore, I would expect to see India and China together take a substantially lower share than they were at a time when their share was above 40 percent. There would be a transfer within IDA from India and China within IDA to the other low-income countries, particularly those of sub-Sahara and Africa.

I want to mention a word about China, because I think it is a very important subject, and I don't believe it is well understood in the world today. China, up through the end of 1984, had been running a current account surplus. That is completely unsustainable. You would expect a country at China's stage of development to be running a substantial current account deficit. The United States did at the comparable stage of development. I maintain China will have to. They will have to run a current account deficit, if they wish to achieve optimal rates of economic development.

Now, when is that coming? It is here. In the first half of this year China had a dramatic change from the current account surplus of prior years to a very substantial current account of deficit. It caused them to draw down their foreign exchange reserves by

something on the order of 50 percent. Now, that is about what I would have expected to happen although I didn't expect it to happen quite that fast. I want to say to you that the world does not have a financial plan for dealing with China's external financial requirements over the next 5 to 10 years. It should. The World Bank will have to play a major role in developing such a plan.

Chairman LUNDINE. Looking at the World Bank itself then, and expanding that beyond the India and China situation, would you support the creation of a third lending window at the Bank which would mix the IBRD and IDA credit?

Mr. MCNAMARA. Which would do what?

Chairman LUNDINE. It would mix them.

Mr. MCNAMARA. Mix them. Well, in a sense that is already done, because if you are going to loan say $50 million to country A, in the past perhaps it was 100 percent IDA, $50 million IDA, zero bank. Now it could be $25 million IBRD and $25 million IDA. So I don't think one needs a new institutional structure within the Bank to do that. You can mix the credits and loans as they are.

Chairman LUNDINE. Do you believe that there could be closer coordination between the IMF's measures to improve liquidity in some of the developing countries, and the World Bank's longer term policy?

Mr. MCNAMARA. I am not sufficiently close to the day-to-day operations of the two institutions today to say whether there could be closer coordination, but I would say without any question there should be close coordination. In many cases there should be joint missions and perhaps even joint financial operations to deal with the two phases of a country's financial problem.

Chairman LUNDINE. It was suggested by one of our earlier witnesses before this subcommittee during this series of hearings that you might try an actual joint negotiation.

Mr. MCNAMARA. I don't want to say no. This is a matter of detail of operations. I do believe in very, very close relationships between those two institutions. I had, as I have already expressed, tremendous admiration for Jacques de Larosiere, and I had the closest possible personal relations with him and I would certainly hope that would continue.

Chairman LUNDINE. In conclusion, I would just like you to explain your perspective of the advantage to the self-interests of the United States of expanding the role of the IMF and multilateral development bank.

Mr. MCNAMARA. I would put it in two categories. I think that the economic advantages are very clear indeed. If you look at our exports to Latin America, those countries have taken in years prior to 1982–83 a very substantial percentage of our total exports. They are a huge market for our goods. They were in the past. They are potentially for the future. They are not a huge market today. The reason is that their rate of growth has dropped substantially as they were forced to move toward austerity by the IMF's conditions which were imposed upon them to achieve balance of payments equilibrium. Lest one thinks that those were unreasonable conditions, the alternative was for somebody to finance higher levels of imports. No one was prepared to do that.

There wasn't any alternative financing source, so the IMF said in effect, you have got to shrink your imports. Now, when they shrank their imports, they shrank our exports because our exports were their imports. So just putting it very, very simply, to help Latin America expand is to create jobs in the United States. I submit to you that is in our interest. We can follow that example elsewhere in the world, but it is easiest to understand close at home.

Politically, it is also in our interest. People say the Soviets are trying to take over Central America, and that they are subverting governments and we may have to use troops to address the issue. I tell you without any qualification whatsoever that the problem in Central America was not in the first instance the result of action initiated by the Soviet Union. The problem in Central America came about because the elite of those countries failed to address the interests of the majority of their people. We didn't insist they do otherwise, and we didn't help them do otherwise.

That situation will exist elsewhere in the world. It is in our political interests to assist the developing country governments to achieve reasonable rates of growth, rates of growth sufficient to assure social advance and political order. I don't guarantee that such rates of growth will lead to political stability, but I do guarantee that if we are insensitive to helping them achieve adequate economic growth, there will be political disorder and the ripple effects of that political disorder will erode our security.

Chairman LUNDINE. I thank you again for your testimony. You have been, as I anticipated, extremely incisive and your analysis will be of great help to us in finalizing the report. I expect the subcommittee will complete its report on the problem of Third World debt later this month. The report and the subcommittees conclusions and recommendations on this complex problem will be made public at this time. The hearing is adjourned.

Thank you very much.

Mr. MCNAMARA. Mr. Chairman, thank you very much indeed.

[Whereupon, at 11:35 p.m., the subcommittee adjourned.]

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